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In the
Supreme Court of the United States

OCTOBER TERM, 1947

NUMBER .....

GRAHAM FLYING SERVICE, a Corporation,
Petitioner.

VS.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT AND BRIEF IN SUPPORT THEREOF

To The Honorable Chief Justice and Associate Justices of the United States Supreme Court:

JURISDICTION

The basis upon which petitioner contends that United States Supreme Court has jurisdiction to review the judgment rendered by The Circuit Court of Appeals Eighth Circuit in this case is found in Judicial Code, Section

240, as amended (Title 28—Judicial Code and Judiciary U. S. C. Section 347) which reads in part as follows:

> "(a) In any case, civil or criminal, in a circuit court of appeals, * * * , it shall be competent for the Supreme Court of the United States, upon the petition of any party thereto, whether government or other litigant, to require by certiorari, either before or after judgment or decree by such lower court, that the cause be certified to the Supreme Court for determination by it with the same power and authority, and with like effect, as if the cause had been brought there by unrestricted writ of error or appeal. * * * "

and in Revised Rules of the Supreme Court of the United States, Rule 38, which reads in part as follows:

> "A review on writ of certiorari is not a matter of right, but of sound judicial discretion, and will be granted only where there are special and important reasons therefor. The following, while neither controlling or fully measuring the court's discretion, indicate the character of reasons which will be considered:
>
> "(a) * * * .
>
> "(b) Where a circuit court of appeals has rendered a decision in conflict with the decision of another circuit court of appeals on the same matter; * * * ; or has decided an important question of federal law which has not been, but should be, settled by this court; or has decided a federal question in a way probably in conflict with the applicable decisions of this court; or has so far departed from the accepted and usual course of judicial proceedings, or so far sanctioned such a departure by a lower court, as to call for an exercise of this court's power of supervision.
>
> (c) * * * ."

The final decision of the Circuit Court of Appeals Eighth Circuit from which this petition is taken was entered on the 25th day of March, 1948 (R. p. 37); and this petition for writ of certiorari to the Circuit Court of Appeals Eighth Circuit is filed with the clerk in this court on the 17 day of June, 1948. Supreme Court Rule 38, Sec. 2, Judicial Code Sec. 8 of the Act of Feb. 13, 1925 (Title 28 U. S. C., Judicial Code and Judiciary Sec. 350).

THE MATTER INVOLVED

Petitioner here, Graham Flying Service, a corporation, on filing its income tax returns and paying its tax for 1941 and 1942, elected to qualify as a Personal Service Corporation not subject to excess profits tax.

The commissioner on examination of taxpayer's returns denied the elections on the ground that taxpayer was not a Personal Service Corporation during the years in question and assessed excess profits tax deficiencies in the amount of $3,622.15 for 1941 and $15,065.52 for 1942. The taxpayer appealed to the tax court from these deficiency assessments.

In order to qualify as a Personal Service Corporation, taxpayer had to come within the requirements of Section 725(a) of the Internal Revenue Code, which reads in part as follows:

> "(a) Definition. As used in this subchapter, the term 'personal service corporation' means a corporation whose income is to be ascribed primarily to the

activities of shareholders who are regularly engaged in the active conduct of the affairs of the corporation and are the owners at all times during the taxable year of at least 70 per centum in value of each class of stock of the corporation, and in which capital is not a material income producing factor; but does not include any foreign corporation, nor any corporation 50 per centum or more of whose gross income consists of gains, profits, or income derived from trading as a principal. * * *

"(b) Election as to taxability. If a personal service corporation signified, in its return under Chapter I, for any taxable year, its desire not to be subject to the tax imposed under this subchapter for such taxable year, it shall be exempt from such tax for such year, * * * ."

Petitioner here, Graham Flying Service, is a corporation in which the president and general manager, E. L. Graham, owned 96 per cent of all the stock during the taxable years in question, 1941 and 1942. He had full power to conduct the affairs of the corporation in any manner he saw fit, and devoted his entire time to its business. (Findings of Fact, R. p. 8.)

Petitioner conducted a flying school which was the principal source of its income during 1941 and 1942 (Findings of Fact, R. p. 8) under contracts with the Civil Aeronautics Administration (Findings of Fact, R. p. 9).

E. L. Graham had learned to fly and to maintain flying boats in the Navy during World War I. He started flying again in 1927 and thereafter flew with increasing frequency. He was licensed as a commercial pilot. Meanwhile, he had acquired considerable experience in the operation and maintenance of motors used in tractors and

trucks as well as aircraft. Shortly after the civilian pilots' training program was instituted by the CAA, he was selected to operate a flying school in conjunction with Morningside College, Sioux City, Iowa. The College participated in the ground school phase of the program. Graham individually opened the flying school in October, 1939, and operated that school for profit under contracts with the CAA. The flying school was operated by petitioner, Graham Flying Service, after its incorporation in September, 1940 (Findings of Fact, R. p. 9).

Graham was petitioner's chief instructor and the only flight examiner on its staff. He was designated as a flight examiner by the CAA in May, 1940, and also held a certificate for maintenance of aircraft. During 1941 he taught one complete class of apprentice instructors and also one complete class of secondary students. He knew practically all of the students personally. He gave spot checks, flight checks, and final flight checks to many students during 1941 and 1942. He personally flew with and either examined or instructed 90 per cent of all students. The remaining tests were given by representatives of the CAA. Graham worked from daylight to dark, usually seven days a week. He devoted about 70 per cent of his time to instruction, including checks and tests, about 20 per cent to supervision of other instructors, and about 10 per cent to managerial duties. He was assisted by five instructors, three mechanics, and two office employees in 1941 and by eleven instructors, four mechanics, three office employees, and three guards in 1942 (Findings of Fact, R. p. 10).

The entire capital for the taxable years under consideration was used to purchase *facilities and equipment* to conduct the flying school (Findings of Fact, R. p. 11) (Stipulation, R. p. 25). The stipulation of facts was incorporated in its entirety by reference by the trial court (Findings of Fact, R. p. 13). The petitioner's stock, its mesne accumulated earnings and its average borrowed capital all was invested in *facilities and equipment* for its flying school (Opinion, R. p. 15). The petitioner operated its flying school at Sioux City Municipal Airport which it rented until the Army took over that field early in 1942. Petitioner then moved to the old Rickenbacker Field, west of Sioux City, which it could not rent but had to purchase. The petitioner also used capital for the construction of an administration building, office facilities, repair shop and hangars. Other capital was used to purchase airplanes, parachutes, and repair parts for training purposes (Findings of Fact, R. pp. 10, 11). At the end of 1941 petitioner owned 13 airplanes and at the end of 1942 it owned a total of 26 airplanes (Findings of Fact, R. p. 11).

Under these findings of fact the Tax Court (trial court) held that capital used entirely to purchase *facilities and equipment* was a material income producing factor during the years in question and that it was therefore unnecessary to determine whether the income of petitioner is to be ascribed primarily to the activities of E. L. Graham, the principal stockholder, and that, therefore, petitioner was not a Personal Service Corporation under the definition (Opinion, R. p. 16). *Graham Flying Service v. C. I. R.*, 8 T. C. 557.

The decision of the Tax Court was affirmed by the Circuit Court of Appeals Eighth Circuit, holding that the determination by the Tax Court is presumptively correct (Opinion, R. p. 34) and that the decision of the Tax Court is warranted by the undisputed facts and that it has a reasonable basis in the law. 166 F. 2d ___ (Opinion, R. p. 37).

The question to be decided in this case is whether or not capital used only to furnish *facilities and equipment* with which to carry on *personal services* (services ascribed primarily to the activities of the principal stockholders) is a material income producing factor under the definition in Section 725(a) quoted above.

THE SPECIAL AND IMPORTANT REASONS WHY THIS COURT IN THE EXERCISE OF SOUND JUDICIAL DISCRETION SHOULD GRANT CERTIORARI ARE:

I.

Several of the Circuit Courts of Appeal have rendered conflicting decisions on the question here involved.

The question here involves the interpretation of the definition of a Personal Service Corporation contained in Section 725(a) of the Revenue Act of 1940, and particularly the interpretation of the clause "and in which capital is not a material income producing factor." The definition reads in part as follows:

> "As used in this subchapter, the term 'personal service corporation' means a corporation whose income is to be ascribed primarily to the activities of shareholders who are regularly engaged in the active conduct of the affairs of the corporation and are the

> owners at all times during the taxable year of at least 70 per centum in value of each class of stock of the corporation, *and in which capital is not a material income producing factor,* • • • ." (Emphasis ours.)

The instant case is the only one within our knowledge in which a circuit court has reviewed the decision of the Tax Court on this precise question under this statute; but the circuit courts have decided this precise question several times under an almost identical statute (Sec. 200, Revenue Act of 1918) in force during and after World War I. The pertinent section of the Revenue Act of 1918 reads in part as follows:

> "The term 'personal service corporation' means a corporation whose income is to be ascribed primarily to the activities of the principal owners or stockholders who are themselves regularly engaged in the active conduct of the corporation *and in which capital (whether invested or borrowed) is not a material income producing factor*;" • • • ." (Emphasis ours.)

The conflicting decisions of the Circuit Courts under this last above quoted definition are as follows:

In *Shipley School v. Collector,* 34 F. 2d 281, where there was a staff of nonstockholding teachers and the corporation had $25,000 invested mostly in furniture and equipment, the Circuit Court of Appeals Third Circuit held that the capital so used was not a material income producing factor; and in *Strayer's Business College v. Com.,* 35 F. 2d 426, where there was a staff of 10 to 12 nonstockholding teachers employed and about $25,000 invested in school equipment, the Circuit Court of Appeals

Fourth Circuit held that the capital so used was not a material income producing factor.

But in *Metropolitan Business College v. Blair,* 24 F. 2d 176 where there was a teaching force of nonstockholding teachers employed and the corporation had about $45,000 invested in desks, chairs, typewriters and other furniture fixtures and teaching paraphernalia, the Circuit Court of Appeals Seventh Circuit held that capital so used was a material income producing factor; and also in *Atlanta-Southern Dental College v. Com.,* 50 F. 2d 34, where there were 17 nonstockholding instructors employed and the corporation had about $100,000 invested in a school building and equipment, the Circuit Court Fifth Circuit held that capital so used was a material income producing factor.

In each of the four above cases with facts identical, in that the capital was used to *purchase facilities and equipment,* the several circuit courts (third and fourth, seventh and fifth) were called upon to interpret the clause in the definition "and in which capital is not a material income producing factor." The third and fourth circuits interpreted that capital so used *was not a material income producing factor* under the definition and the seventh and fifth circuits interpreted directly opposite and in direct conflict and held that capital so used *was a material income producing factor under the definition.*

In the instant case with facts identical with the facts in the four above cited cases, in that there were 5 nonstockholding instructors in 1941 and 11 in 1942 and the capital was used only to purchase *facilities and equip-*

ment, the Circuit Court of Appeals Eighth Circuit has affirmed the decision of the Tax Court, holding that the capital so used was a material income producing factor, citing and following the interpretation of the seventh and fifth circuits placed on the pertinent clause of the definition. Either the third and fourth circuits are in error or the seventh and fifth are in error. Taxpayer here contends that the seventh and fifth circuits are in error and, if allowed certiorari, will attempt to show that the eighth circuit in following the seventh and fifth circuits is in error and that its decision should be reversed.

II.

The Circuit Court decided a federal question of substance not heretofore determined but one which should be settled by this court. Brooklyn Savings Bank v. O'Neil, 324 U. S. 695-697, 89 L. ed 1296.

The Circuit Court here, by affirming the decision of the tax court interpreted the clause in the definition of a Personal Service Corporation "capital is not a material income producing factor" to mean that capital used to furnish *facilities and equipment* to carry on personal services performed by the principal stockholders is a *material income producing factor.* This is a decision of a substantial federal question in that it is a construction placed upon the federal statute, Sec. 725 of the Revenue Laws of the United States. It has to do with the financial support of the federal government. It involves the question of whether or not many corporations will contribute substantially to the financial support of the federal government by paying excess profits taxes. It vitally concerns such taxpayers in arriving at a decision whether or not

to elect under a Personal Service Corporation classification when making excess profits tax returns and paying federal taxes. If not settled by this court the result will be unending litigation and utter confusion and conflict in the lower courts and the courts of the several circuits. The Tax Court in the instant case has decided that the amount of capital used to purchase *facilities and equipment* to carry on personal services is a matter of degree or approximation (R. p. 14) which means that the taxpayer and the commissioner must guess in each particular case whether there is too much capital so used by the taxpayer; resulting in a controversy in each case; and the Tax Court when called upon to referee the matter must arbitrarily determine whether or not there is too much capital so used. Under such a ruling the definition is rendered meaningless, and leaves the clause "capital is not a material income producing factor" uninterpreted. Congress would not have defined a Personal Service Corporation without intending that some corporation could qualify. Every corporation must have *facilities and equipment,* including *Personal Service Corporations.* An exhaustive search of the reported cases discloses that this question has never been considered or decided by this court. A perusal of the opinions in the hundreds of cases decided by the lower courts discloses that the question is left in utter confusion and conflict and will remain so in the many cases yet to be decided unless this court exercises its power of supervision. A great many of the cases on this question arising out of the Excess Profits Tax law in force during and immediately after World War I did not reach the Circuit Courts until the 1930's.

Insofar as we have been able to ascertain the instant case is the first one on this question reaching a circuit court under the Excess Profits Tax law of 1940. It is therefore safe to say that the several Circuit Courts will be confronted with this same question many times for many years to come.

III.

The Circuit Court here decided a federal question in conflict with applicable decisions of this court.

The Circuit Court held (R. p. 34) that "the facts are undisputed but the conclusion or inference to be drawn from them is a mixed question of law and fact," citing *Dobson v. Commissioner of Internal Revenue,* 320 U. S. 489-507, 88 L. ed 248, and went on to say, "The statute enumerates certain prerequisites as necessary to a classification as a personal service corporation. One of the requisite conditions is that 'capital is not a material income producing factor,' " and held (R. p. 37), "We think the decision of the Tax Court warranted by the undisputed facts and that it has a 'reasonable basis in the law.' " The undisputed facts are that all the services performed by the taxpayer were personal services, that all the services performed were under the direct supervision and control and in a great part actually performed by E. L. Graham, the principal stockholder, and that all of the capital was used to purchase *facilities and equipment* used by E. L. Graham to perform the personal services. Under such facts the only logical conclusion or inference that can be drawn is that the capital in and of itself produced no income, that there is no mixed question of

law and fact, and that the conclusion or inference (that capital was a material income producing factor) drawn by the Tax Court, has no reasonable basis in the law. The elements of the decision of the Tax Court here are separable, so as to identify the holding as a clearcut mistake of law. The Tax Court here distinguished with clarity between its findings of fact and conclusions of law (R. p. 8, Findings of Fact and R. p. 13, Opinion). But the Tax Court erroneously applied the law to the facts; and it is the function of the reviewing courts to correctly apply the law to the facts as found. The Tax Court has erroneously construed the definition of a Personal Service Corporation by holding that capital used to purchase *facilities and equipment* used by the principal stockholders in performing personal services is capital producing income. Every personal service corporation must have a place in which to function and tools with which to perform. The definition presupposes that. It is not for the administrative body to decide how much or how little capital can be so used. It is for the courts to ultimately say what is meant by the definition.

It is therefore asserted that the decision here is in conflict with the rule laid down in the Dobson case, supra, where this court said:

> "It is contended that the applicable statutes and regulations properly interpreted forbid the method of calculation followed by the Tax Court. If this were true the Tax Court's decision would not be in accordance with the law and the court would be empowered to modify or reverse it. Whether it is true is a clearcut question of law and is for decision by the Courts."

In the instant case the Tax Court did not properly interpret the meaning of the clause in the definition "capital is not a material income producing factor." The interpretation made by the tax court renders the statute meaningless in its entirety and frustrates the intention of Congress, for no corporation can perform personal services without space and tools, which of necessity involve capital. We contend here that the method used by the Tax Court in arriving at its interpretation of this clause of the definition is forbidden by the statute itself. Congress never intended that $100 invested in *facilities and equipment* used by the principal stockholders to carry on *personal services* would not be too much in one case nor that $101 would be too much in another case. Congress intended that *capital* invested in *facilities and equipment* with which the *principal stockholders* perform *personal services* does not *materially produce* income.

Wherefore Petitioner respectfully prays that a writ of certiorari be issued out of and under the Seal of this Honorable Court, directed to the United States Circuit Court of Appeals, Eighth Circuit, commanding that court to certify and to send to this court, for its review and determination, on a day certain, to be therein named, a full and complete transcript of the record and all proceedings in this case, numbered and entitled on its docket as No. 13,621, Graham Flying Service, a corporation, Appellant vs. Commissioner of Internal Revenue, Respondent, and that the judgment of the Circuit Court of Appeals, Eighth Circuit, be reviewed by this Honorable Court and reversed, and prays for such other, further

and additional relief as this court may deem just and equitable in the premises.

GRAHAM FLYING SERVICE,
a corporation, pro se.
BY WILLIAM W. GRAHAM,
Vice President.

BRIEF IN SUPPORT OF PETITION FOR CERTIORARI

The facts and the questions involved are set forth in detail in the accompanying petition for certiorari and are hereby made a part of this brief by this reference.

POINTS RELIED UPON FOR CERTIORARI

I.

Several of the Circuit Courts of Appeal have rendered conflicting decisions on the question here involved.

Shipley School v. Collector, 34 F (2nd) 281.

Strayers Business College v. Com., 35 F. (2nd) 426.

Metropolitan Business College v. Blair, 24 F. (2nd) 176.

Atlanta Southern Dental College v. Com., 50 F. (2nd) 34.

U. S. C., Title 26, Internal Revenue, Sec. 725(a).

U. S. C., Title 28, Judicial Code and Judiciary, Sec. 347(a).

Rule 38, Supreme Court Rules.

II.

The Circuit Court decided a federal question of substance not heretofore determined by this court, but one which should be settled by this court.

Brooklyn Savings Bank v. O'Neil, 324 U. S. 695-697, 89 L. ed. 1296.

Revenue Act of 1918, Sec. 200.

Graham Flying Service v. Com., 166 F. (2nd) .....

Bryant and Stratton Commercial School, Inc. v. Com., 1 B. T. A. 32.

Fuller and Smith v. Collector, 23 F. (2nd) 959.

Posse-Nissen v. U. S., 25 F. (2nd) 748.

Iredell v. DeLaski, etc., 290 F. 955.

Alexander, Conover & Martin v. Com., 45 F. (2nd) 383.

Shipley School v. Collector, 34 F. (2nd) 281.

Van Hummel v. Com., 3 T. C. 101.

H. Newton Whittelsey, Inc., v. Com., 9 T. C. 95.

III.

The Circuit Court of Appeals, Eighth Circuit, decided a Federal question in a manner in conflict with the applicable decisions of this court.

Dobson v. Com., 320 U. S. 489-507, 88 L. ed. 248.

Revenue Act of 1918, Sec. 200.

Graham Flying Service v. Com., 166 F. (2nd) ....

Bryant and Stratton Commercial School, Inc., v. Com., 1 B. T. A. 32.

Fuller and Smith v. Collector, 23 F. (2nd) 959.

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Iredell v. DeLaski, etc., 290 F. 955.

Alexander, Conover & Martin v. Com., 45 F. (2nd) 383.

Shipley School v. Collector, 34 F. (2nd) 281.

ARGUMENT

I.

Several of the Circuit Courts of Appeal Have Rendered Conflicting Decisions on the Question Here Involved.

As we have said, the question here involved is—When is capital a material income producing factor under the definition prescribed by Congress in Section 725(a) of the Second Revenue Act of 1940? Two cases we have cited in our petition, supra, hold that about $25,000 invested in *facilities and equipment* was not a material income producing factor;

Shipley School v. McCaughn, 34 F. (2nd) 281.

Strayers Business College v. Com., 35 F. (2nd) 426.

and another two cases we have cited in our petition, supra, hold that about $45,000 and $100,000, respectively, invested in *facilities and equipment* was a material income producing factor.

Metropolitan Business College v. Blair, 24 F. (2nd) 176.

Atlanta Southern Dental College v. Com., 50 F. (2nd) 34.

As said by the Trial Court (Opinion, R. p. 14), "In each of these cases the stockholders were assisted by other

teachers and capital was invested in *school equipment.*" The Trial Court also said, "It is hard to reconcile many of the former decisions" and also said, "The differences between these cases were differences in degree. For example, in the first two cases the amount of capital was $25,000 or less; in the latter cases the capital was about $100,000." (Difference in amount of capital used for the same purpose.) In other words, the facts in these conflicting decisions are parallel except for the *amount of capital* used for but one purpose to provide *facilities and equipment.* In the instant case it is stipulated by the parties (R. p. 25) and found by the Trial Court (R. p. 11) that the entire capital for the taxable years under consideration was used to purchase *facilities and equipment* to conduct the flying school. Naturally, petitioner here, like many another taxpayer now and in the future, will wonder where the dividing line is. If $25,000 invested in *facilities and equipment* is not too much to qualify, is $30,000 too much? Is $40,000 too much? Is $50,000 too much? If $25,000 is not too much to spend for *facilities and equipment* to conduct the Shipley School, a boarding school, why is $45,000 too much to spend for *facilities and equipment* to conduct the Metropolitan Business College, a business school? If $25,000 is not too much to spend for *facilities and equipment* to conduct Strayers Business college, a business school, why is $100,000 too much to spend for *facilities and equipment* to conduct the Atlanta Southern Dental College, a dental school, or why is $34,689.50 in 1941 and $97,910.82 in 1942 (R. p. 12) too much to spend for *facilities and equipment* to conduct Graham Flying Service, a flying

school? Or, put it this way, since $25,000 was not too much for the Shipley School, would $45,000 have been too much? Since $25,000 was not too much for Strayers Business College, would $100,000 have been too much? No, the amount spent for tools is not the test when the taxpayer performs personal services. The Circuit Courts should be put straight on this question. All taxpayers performing personal services must have *facilities and equipment* with which to work—some more, some less. If the amount of the cost is arbitrarily made the test, the intent of Congress will be frustrated, for under such a rule few, if any, can qualify. For the benefit of all concerned—the Government, the Revenue Department, the taxpayer, and the Courts—this court, in the exercise of its sound judicial discretion and power of supervision should grant certiorari and decide this substantial question.

II.

The Circuit Court of Appeals, Eighth Circuit, in the Instant Case Decided a Federal Question of Substance not Heretofore Determined by This Court, but One Which Should Be Settled by this Court. Brooklyn Savings Bank v. O'Neil, 324 U. S. 695-697, 89 L. ed. 1296.

As we have said, the question involved here is whether or not capital used to furnish *facilities and equipment* with which to carry on *personal services* is a material income producing factor under the definition prescribed by Congress in Section 725(a) of the Revenue Act of 1940.

The Circuit Court has held in this case that capital used by a corporation solely to furnish *facilities and*

equipment with which to perform *personal services* is a material income producing factor under the definition. This is a decision of a substantial question, for all personal service corporations must have *facilities and equipment;* and, therefore, if the decision is correct, the statute amounts to a nullity, for under such decision no corporation can qualify as a Personal Service Corporation.

This is a substantial question, for it involves the interpretation of a Federal statute enacted by Congress under the revenue laws of the United States. It has to do with the financial support of the Federal Government. On the interpretation depends whether many corporations will or will not be classified as personal service corporations, exempt from payment of excess profits taxes; thereby involving substantially the support of the Federal Government.

This court has never yet entertained or decided this important and substantial Federal question insofar as we have been able to ascertain by an exhaustive search through the reported cases. The several Circuit Courts have made many conflicting decisions touching this question under the Revenue Acts of 1918 and 1921; Shipley School v. McCaughn, supra; Strayers Business College v. Com., supra; Metropolitan Business College v. Blair, supra; Atlanta Southern Dental College v. Com., supra; and many others. The Circuit Court of Appeals, Eighth Circuit, in the instant case, is the only circuit court which has decided this question under the Revenue Act of 1940, insofar as we have been able to find; and has decided it in a manner which in no way leads to clarification; *Graham Flying Service v. Com.*, 166 F. (2nd) .....

The Circuit Court erred in affirming the decision of the Tax Court holding that because the *facilities and equipment* used by E. L. Graham, the principal stockholder, cost so much, it was unnecessary to determine whether the income is to be ascribed primarily to activities of E. L. Graham, the principal stockholder. See R. p. 16, where the Trial Court said:

> "The income was earned in a large part by the use of the airplanes in which it had invested substantial capital."

Under the definition it can never be determined whether capital is a material income producing factor without determining whether the income is to be ascribed primarily to the activities of the principal stockholders where the only use to which capital is put is to buy *facilities and equipment* with which to operate. It must be first determined whether or not income can be ascribed primarily to the activities of the principal stockholders before considering whether or not capital invested in *facilities and equipment* is a material income producing factor. The Tax Court in effect holds that were it not for the fact that so much money was expended for *facilities and equipment,* the income would be ascribed primarily to the activities of E. L. Graham, the principal stockholder, by deciding the question on the ground that capital was a material income producing factor, regardless of how and by whom the *facilities and equipment* were used. Space does not permit a summary of the facts here, but see the findings of fact in the opinions of the Tax Court in the recent cases of *Van Hummel v. Com.,* 3 T. C. 101, and *H. Newton Whittelsey, Inc., v.*

Com., 9 T. C. 95, where the Tax Court recently held that the income is to be ascribed to the principal stockholders.

The Circuit Court of Appeals, Eighth Circuit, holds that, were it not for the fact that so much money was expended for *facilities and equipment*, the income would be ascribed primarily to the activities of E. L. Graham, manager and principal stockholder (Opinion, R. p. 35) where the Circuit Court said:

> "Counsel places great emphasis upon the importance of services of petitioner's manager and principal stockholder, and certainly they were very considerable and very essential to the success of its business and the production of its income. But can it be said that without the airfield and without the aircraft and other facilities, Mr. Graham's activities could have produced the income * * * ?"

Of course, E. L. Graham could not have produced the income without the *facilities and equipment.*

Clearly capital invested in *facilities and equipment* to be used beyond the activities of the principal stockholders (shareholders not using the tools), is capital producing income. Such as capital invested by one in an airport and airplanes and leased to another to conduct a flying school. If E. L. Graham had invested $75,000 in airplanes and leased them to John Doe at a certain rental to conduct a flying school, the income to E. L. Graham would have been produced by capital; or if E. L. Graham had invested $30,000 in an airport, shop and hangars and leased them to John Doe at a certain rental, the income to E. L. Graham then would have been produced by cap-

ital. If E. L. Graham had bought and sold airplanes (trading as a principal) the income, even though very slight, would be produced by capital. If E. L. Graham had loaned $75,000 to John Doe to buy airplanes and $30,000 to buy an airport to conduct a flying school, the interest on the loans received by E. L. Graham would be income produced by capital. If E. L. Graham had loaned John Doe $3 to buy a pick and shovel with which to excavate, the interest on the loan received by E. L. Graham would be income produced by capital. But if E. L. Graham had spent $3 to buy a pick and shovel to excavate for profit, the income would not be from the capital invested but would be from the personal activities of E. L. Graham. To be consistent with the decision made in the instant case, the Tax Court and the Circuit Court would have to hold that the excavating must be done with the bare fingernails in order to qualify as a personal Service Corporation. Where the shareholders are regularly engaged in the active conduct of the affairs (shareholders using the tools) the money used to purchase *facilities and equipment* cannot be considered a material income producing factor; for personal service cannot be carried on without a place to perform and tools to work with.

The Tax Court held that where one corporation spends $25,000 for *facilities and equipment* and another spends $100,000 for *facilities and equipment*, the difference is a difference in degree (R. p. 14). We can only discern a difference in amount, not a difference in degree. The degree or approximation rule comes into play where the taxpayer spends so much money for tools that he owns so many tools that he cannot use them all himself, and perforce

must let others use them while he reaps a part of the income from the efforts of such others. In such a case the money spent for the surplus tools becomes capital materially producing income—invested capital. See *Fuller and Smith v. Com.*, 23 F. (2nd) 959. The Tax Court said (R. p. 15) that we did not afford any breakdown of the income derived from capital. Since all our capital was invested in *facilities and equipment,* we assume the court meant we did not show how much income was attributable to the airplanes and the airfield and the shop and the hangars. We submit that, by showing that the income is ascribed primarily to the activities of E. L. Graham in using the airplanes, airfield, shop, and hangars, we showed that none of the income was derived from capital. To be consistent, the Tax Court would have a taxpayer using a pick and shovel break down the figures and show how much the pick earned, how much the shovel earned, and how much income could be attributed to the tired muscles. The Circuit Court affirmed this holding saying (R. p. 35):

> "There was no proof showing what portion of the income was attributable to personal services and what portion was attributable to invested capital."

From the very beginning, in interpreting the definition the courts have recognized that the use of *facilities and equipment* are necessary to every corporation, and that, therefore, money so used cannot be considered capital producing income.

In *Bryant and Stratton Commercial School, Inc., v. Com.*, 1 B. T. A. 32, the court said:

"It is only when capital is important in the production of income that the definition does not apply. The common case of a manufacturing corporation receiving its income from the sale of goods produced by its plant is clearly outside the classification. *But school desks and blackboards do not produce income except remotely.*" (Emphasis ours.)

In Fuller and Smith v. Collector, supra, the court said:

"Those holdings likewise are to the effect that the presence and use of capital, such as required to provide and maintain an office, with *elaborate present-day equipment* * * *, do not make capital a material income producing factor * * *. The law was directed at absentee stock ownership. If the service rendered is in the nature of personal service and is rendered by the owners of the business, the law intended a separate classification for income and excess profit taxes. * * * The discrimination is between income earned by capital and income earned by personal effort. * * * The law intended to forbid absentee stock interests of a material size." (Emphasis ours.)

In the case of *Posse-Nissen v. U. S.*, 25 F. (2nd) 748, where the taxpayer had $38,911 invested in real estate and building and $1,400 in furniture and fixtures, the court said:

"If the petitioner had rented, rather than owned the building in which it conducted its training school, the fact that it might become necessary to use its capital for payment of rent, * * * would not be sufficient to deprive it of its status as a personal service corporation.

"If I understand the argument made on behalf of the Government, it is that the petitioner had invested its capital and surplus in a building which it

used for a gymnasium, for offices, schoolrooms, and other school purposes, and that the capital so invested was, therefore, a material income producing factor. But the investment yielded no income apart from the services rendered. The income producing factor was the personal service rendered by the principal stockholders and their assistants. So far, therefore, as this property was employed for corporate purposes, it cannot be said that it was an income producing factor. *Every personal service corporation must have capital invested in equipment and tools necessary to carry on its work.*" (Emphasis ours.)

In *Iredell v. DeLaski, et al.*, 290 F. 955, where the taxpayer had $12,000 invested in a fund from which to advance salaries, wages, etc., and to provide office furniture, accommodations and equipment, the Trial Court found as a fact that taxpayer had *no* invested capital and the Third Circuit Court affirmed.

In the case of *Alexander, Conover & Martin v. Com.*, 45 F. (2nd) 383, where taxpayer had $66,000 invested in office furniture and fixtures, stock exchange memberships, Liberty Bonds, and miscellaneous assets, the Circuit Court in holding that taxpayer was a personal service corporation said:

> "Invested capital was not a material income producing factor, if it was used solely as a fund from which to advance salaries, wages, etc., and to provide office furniture, accommodations, etc."

In Shipley School v. Collector, supra, where there was $25,000 invested in furniture and equipment, the corporation was held to be a personal service corporation, and the court said:

> "The income of the school comes not from the meager capital employed but in reality from the personal services rendered by these women drawing to it the patronage it enjoys * * * . In holding this personal school as falling within the exemption of the statute, we construe the law as it is and as Congress meant it should be."

We respectfully submit that this court in the exercise of its sound legal discretion should grant certiorari in order that it may be decided once and for all whether or not capital invested in *facilities and equipment* only and used by the principal stockholders to carry on personal services is or is not a material income producing factor under the definition.

III.

The Circuit Court Decided a Federal Question in Conflict with Applicable Decisions of this Court. Dobson v. Com., 320 U. S. 489-507, 88 L. ed. 248.

The Tax Court found in its findings of fact that petitioner conducted a flying school which was the principal source of its income in 1941 and 1942 (R. p. 8); and that the petitioner entered into various contracts with the CAA (Civil Aeronautics Administration) for the purpose of giving flight instruction to student pilots assigned by Morningside College; and that in performing those contracts petitioner was required to provide a certain ratio of approved aircraft to students, to maintain equipment and facilities in accordance with prescribed standards, and to furnish dual check and solo instruction in accordance with prescribed flight curricula (R. p. 9); and the Tax Court incorporated the stipulation of facts in its

entirety (R. p. 13), in which stipulation the parties agreed that $71,297.31 of the income for 1941 and $131,178.23 of the income for 1942, came from the CAA for performing these contracts (R. p. 24), and found that petitioner received $75,729.17 in 1941 and $137,504.96 in 1942 as compensation from all sources for flight instruction (R. p. 12). In other words, the Tax Court found that practically all of the income for the taxable years in question was made from performing these contracts for the CAA. Yet, in the face of these specific findings of fact, the Tax Court in its opinion insinuates that a substantial part of the income was derived from leasing the airplanes to students to make solo flights (R. p. 16). When the facts as stipulated and found by the court are that all the income came from performing contracts with the CAA, the conclusion cannot be drawn that a substantial part of the income came from leasing airplanes to student pilots. Such a conclusion has no reasonable basis in the law. The Circuit Court of Appeals, Eighth Circuit, was bound by the specific findings of fact, not by the conclusions drawn by the Tax Court from such findings. To be sure, the income was earned in a large part by E. L. Graham using the airplanes for tools with which to perform these contracts by teaching students how to fly, but not by investing capital in airplanes to be used in a large part to rent out to pilots. Here the Tax Court found that all the *facilities and equipment* was used to perform specific contracts with the CAA, and yet held that the *facilities and equipment* was leased a substantial part of the time to student pilots. Here the Tax Court found that all the income of petitioner was derived from fulfilling specific

contracts with the CAA, and yet held that a substantial part of the income was derived from leasing its *facilities and equipment* to student pilots. Under such findings of fact the conclusions drawn by the Tax Court have no basis in the law and are reversible error, and the Circuit Court of Appeals by affirming, decided the question contrary to the rule laid down by this court in the Dobson case, supra.

The Circuit Court of Appeals also erred in holding that the capital of petitioner "was not solely utilized in the form of salaries, wages, office rent, etc." (R. p. 35.) The stipulation of facts shows that it was so utilized (R. p. 25, par. 7) where it says "that the entire capital for the taxable years under consideration was used to purchase *facilities and equipment* to conduct the training school." (Emphasis ours.) The findings of fact made by the Trial Court show that it was so utilized (R. p. 11) where the Trial Court found:

> "The entire capital for the taxable years under consideration was used to purchase *facilities and equipment* to conduct the flying school." (Emphasis ours.)

The Trial Court also adopted in its entirety the stipulation of facts and incorporated the stipulation in its findings of fact by reference (R. p. 13). The Trial Court also found (R. p. 10):

> "The petitioner operated its flying school at Sioux City Municipal Airport, which it leased, until the Army took over in 1942. It then moved to the old Rickenbacker field west of Sioux City, which it could not lease but had to purchase for approximately $21,000. The initial payment of $3,000 was made in

> cash from accumulated earnings. The petitioner also spent $8,000, about half of which it borrowed, for construction of an administration building, office facilities, repair shops, and hangars. Other capital was used to purchase airplanes, parachutes, and repair parts for training purposes."

And in its opinion the Trial Court said (R. p. 15):

> "The petitioner's stock, its mesne accumulated earnings and its average borrowed capital were not less than $24,000 in 1941 and $60,000 in 1942, *all of which was invested in facilities and equipment for its flying school.* * * * They also show that it had assets consisting of furniture, equipment (including airplanes and parachutes) less depreciation of $34,689.50 at the end of 1941 and $97,910.82 at the end of 1942." (Emphasis ours.)

Such findings of fact do not warrant the conclusion drawn by the Tax Court, that capital was a material income producing factor, for the facts show that all the capital was expended for providing a place in which to work and tools with which to carry on the personal services. The decision has no "reasonable basis in the law." Dobson v. Com., supra. It is submitted that salaries, wages, office rent, etc., includes facilities and equipment of every kind and nature when the salaries, wages, office rent, facilities and equipment are used by the principal stockholders in performing personal services. Shipley School v. McCaughn, supra; Bryant & Stratton Commercial School v. Com., supra; Fuller & Smith v. Collector, supra; Posse-Nissen v. U. S., supra; Iredell v. DeLaski, etc., supra; Alexander, Conover & Martin v. Com., supra.

The Circuit Court of Appeals also erred in holding that "there was no proof showing what portion of the income was attributable to personal services and what

portion was attributable to invested capital" (R. pp. 35, 36). The stipulation of facts (R. p. 24) shows that the following income was attributable to personal services:

	1941	1942
Flying lessons CAA	$71,297.31	$131,178.23
Flying lessons to others	4,431.86	6,326.73
Passenger flights	1,203.79	1,107.75
	$76,932.96	$138,612.71

and that the following income was not attributable to personal services:

	1941	1942
Airplane repairing	$ 185.18	$ 212.89
Miscellaneous income	1,308.30	487.30
Field rent	-	150.00
Storage sales	695.50	742.25
Miscellaneous sales	38.46	11.55
	$2,227.44	$1,603.99

The Trial Court specifically found the above statement to be true by incorporating in entirety the stipulation of facts (R. p. 13). The Trial Court also found (R. p. 12) as follows:

> "The petitioner received $75,729.17 in 1941 and $137,504.96 in 1942 as compensation from all sources for flight instruction. It derived additional income of $4,176.63 in 1941 and $2,711.73 in 1942 from charter flights, the storage and repair of private planes and miscellaneous sales and services."

Then the Trial Court said (R. p. 15):

> "The petitioner * * * has not afforded us with any breakdown of the income derived from its capital."

Right here is the breakdown—$4,176.63 in 1941 and $2,711.73 in 1942 from the use of capital without performing personal services, which we submit is purely incidental as against $75,729.17 in 1941 and $137,504.96 in 1942 for personal services. The Trial Court also said in the face of these findings of fact:

> "There is ample evidence that capital was an income producing factor."

and the Circuit Court in affirming said (R. p. 36):

> "We cannot say that the use of capital was merely incidental."

Under the findings of fact such conclusions drawn by the Trial Court and affirmed by the Circuit Court have no "reasonable basis in the law." Dobson v. Com., supra.

We submit that the Circuit Court of Appeals, Eighth Circuit, in affirming the decision of the Tax Court decided this Federal question in a manner in conflict with the decision of this court in the Dobson case and that therefore certiorari should be granted.

In conclusion, it is respectfully submitted that this court in the exercise of its sound legal discretion should grant a writ of certiorari to the Circuit Court of Appeals, Eighth Circuit, on any one or all of the special and important reasons set forth in our petition for certiorari and enlarged upon in this argument.

GRAHAM FLYING SERVICE,
a corporation,
Petitioner, pro se.

By: WILLIAM W. GRAHAM,
Vice President.

POINTS RELIED UPON FOR REVERSAL

I.

The Circuit Court erred in holding that the petitioner, Graham Flying Service, a corporation, did not qualify as a personal service corporation under the definition in U. S. C., Title 26, Sec. 725(a) for the years in question.

II.

The Circuit Court erred in holding that capital was a material income producing factor of the income of petitioner for the years in question.

III.

The Circuit Court erred in holding that, under the facts found by the Tax Court and the stipulation of fact entered into by the parties and incorporated in the findings of fact, there was no proof showing what portion of the income was attributable to personal services and what portion was attributable to invested capital.

IV.

The Circuit Court erred in holding that petitioner under the facts, as found by the Trial Court, did not sustain the burden of proving that capital was not a material income producing factor.

V.

The Circuit Court erred in affirming the holding of the Trial Court that, where all capital of corporation taxpayer is invested in facilities and equipment used to

carry on personal services, the amount invested is a question of degree or approximation.

VI.

The Circuit Court erred in holding that, under the findings of fact and conclusions of law of the Trial Court, there is a reasonable basis in the law for the Tax Court's decision.

VII.

The Circuit Court erred in affirming the holding of the Trial Court, that under the facts the facilities and equipment was leased a substantial part of the time to student pilots.

VIII.

The Circuit Court erred in affirming the holding of the Trial Court that, under the facts, there is ample evidence that capital was a material income producing factor.

IX.

The Circuit Court erred in holding that taxpayer is not a personal service corporation under the definition where all of the capital of the corporation is used to furnish facilities and equipment with which to perform personal services.

X.

The Circuit Court erred in holding that where the income is to be ascribed primarily to the activities of the principal stockholders, capital used solely to furnish facilities and equipment is a material income producing factor.

APPENDIX

8 T. C. No. 65

THE TAX COURT OF THE UNITED STATES

GRAHAM FLYING SERICE, a corporation,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Docket No. 9612 Promulgated March 20, 1947.

The petitioner, through its president (who owned 96 per cent of its stock) and a staff of assistants, conducted a flying school. A substantial amount of capital was used to purchase facilities and equipment, including aircraft, required for the school. *Held,* on the facts, that petitioner is not a personal service corporation as defined in section 725(a).

Wm. W. Graham (an officer), for the petitioner.
Richard A. Jennings, Esq., for the respondent.

The Commissioner determined overassessments and deficiencies for 1941 and 1942 as follows:

1941	Overassessment	Deficiency
Income Tax	$1,013.99	
Declared Value Excess Profits Tax		$ 97.71
Excess Profits Tax		3,622.15
1942		
Income Tax	$4,248.42	
Declared Value Excess Profits Tax		$ 184.03
Excess Profits Tax		15,065.52

The issues are whether the petitioner was entitled to exemption from excess profits tax as a personal service corporation during both years, and if so entitled, whether it signified its desire to be exempt for 1941. under section 725 of the Code, as amended.

FINDINGS OF FACT

The petitioner is an Iowa corporation doing business near Sioux City, Iowa. It filed its returns with the collector of internal revenue for the district of Iowa.

The petitioner conducted a flying school which was the principal source of its income during 1941 and 1942. Its president and general manager was E. L. Graham, who had full power to conduct its affairs in any manner he saw fit. He owned 96 per cent of all the capital stock issued by the petitioner and devoted his entire time to its business. The balance of the stock was owned in equal shares by his wife and his brother, who were secretary and vice-president, respectively. They had nothing to do with the business affairs or management of the petitioner. None of the employees of the petitioner had anything to do with its management.

Graham had learned to fly and to maintain flying boats in the Navy during World War I. He started flying again in 1927 and thereafter flew with increasing frequency. He was licensed as a commercial pilot. Meanwhile, he had acquired considerable experience in the operation and maintenance of motors used in tractors and trucks, as well as aircraft. Shortly after the civilian pilots' training program was instituted by CAA (the Civil Aeronautics Administration) he was selected to operate a flying school in conjunction with Morningside College, Sioux City, Iowa. The college participated in the ground school phase of the program. Graham opened the flying school in October, 1939, and operated that school for profit under contract with CAA. He taught some of the college classes without compensation. The flying school was operated by the petitioner after its incorporation in September, 1940.

The petitioner entered into various contracts with CAA for the purpose of giving flight instruction to student pilots assigned by Morningside College. Under the terms of those contracts the petitioner was required to provide

a certain ratio of licensed instructors to students, to provide a certain ratio of approved aircraft to students, to maintain equipment and facilities in accordance with prescribed standards, and to furnish dual, check, and solo instruction in accordance with prescribed flight curricula and within specified schedules of flying time. Between 300 and 400 students received instruction in the courses offered by the petitioner during 1941 and 1942. Most of the instruction consisted of a primary and a secondary course. A heavier type of airplane was used in the secondary course. The ratio of primary trainees to secondary trainees was approximately two to one. The petitioner received $290, later increased to $370, for each student who completed the primary course of 35 to 40 flight hours. It received approximately $800 for each student who completed the secondary course of 40 to 50 flight hours. The petitioner also offered courses for training flight instructors, commercial, and cross-country pilots. Compensation for incompleted courses was paid at hourly rates.

Graham was the petitioner's chief instructor and the only flight examiner on its staff. He was designated as a flight examiner by CAA in May, 1940, and also held a certificate for maintenance of aircraft. During 1941 he taught one complete class of apprentice instructors and also one complete class of secondary students. He knew practically all of the students personally. He gave spot checks, flight checks, and final flight tests to many students during 1941 and 1942. He personally flew with and either examined or instructed 90 per cent of all students. The remaining tests were given by representatives of CAA. Graham worked from daylight to dark, usually seven days a week. He devoted about 70 per cent of his time to instruction, including checks and tests, about 20 per cent to supervision of other instructors, and about 10 per cent to managerial duties. He was assisted by five instructors, three mechanics and two office employees who earned $24,537.14 in 1941, and by eleven instructors, four mechanics, three office employees and three

guards who earned $45,064.33 in 1942. Graham's salary was $3,600 in 1941 and $9,600 in 1942.

The petitioner operated its flying school at the Sioux City Municipal Airport, which it leased, until the Army took over that field early in 1942. It then moved to the old Rickenbacker Field, west of Sioux City, which it could not lease but had to purchase for approximately $21,000. The initial payment of $3,000 was made in cash from accumulated earnings. The petitioner also spent $8,000, about half of which it borrowed, for the construction of an administration building, office facilities, repair shops, and hangars. Other capital was used to purchase airplanes, parachutes, and repair parts for training purposes. Depreciation schedules attached to the petitioner's amended income tax returns for 1941 and 1942 show that at the end of 1941 it owned 13 airplanes which had cost $34,960.42, and that at the end of 1942 it owned a total of 26 airplanes which had cost a total of $77,707.80. Except in the case of five planes acquired from Graham in exchange for stock, the petitioner purchased its aircraft by making a down payment of 10 per cent from earnings and borrowing the balance of the purchase price from the Reconstruction Finance Corporation, for which the aircraft and the contracts with CAA were used as security. The petitioner rented two airplanes for a period of three months in 1941.

The cost of fuel and oil used in the type of airplanes owned by the petitioner was $1 to $1.20 per hour on the smaller planes; gasoline alone for the larger types of planes was $10.50 to $11 per hour. When those planes were rented on occasion to pilots the petitioner received $8 per hour for the smaller planes and $15 to $18 per hour for the larger planes, which included the cost of fuel and oil. The petitioner reported in its amended income tax returns that the cost of plane operation and maintenance was $16,803.63 in 1941 and $23,192.12 in 1942.

The capital stock of the petitioner had a book value of $8,453. That amount represents the stipulated value of

personal property furnished by Graham at the time of incorporation in exchange for all of the stock. The petitioner had accumulated earnings as follows: $917.96 at January 1, 1941, $13,602.41 at January 1, 1942, and $20,728.77 at December 31, 1942. The average borrowed capital of the petitioner was $8,742.67 in 1941 and $34,399.34 in 1942. The entire capital for the taxable years under consideration was used to purchase facilities and equipment to conduct the flying school.

The petitioner's amended income tax returns for 1941 and 1942 contained balance sheets as of the end of those years as follows:

Assets	Dec. 31, 1941	Dec. 31, 1942
Cash	$ 7,363.38	$ 1,191.46
Notes and accounts receivable	11,958.78	48,898.05
Inventories	384.34	844.83
Deposit on airplane	125.00	390.00
Furniture, equipment (including airplanes and parachutes) less depreciation	34,689.50	97,910.82
Prepaid expenses	2,590.77	6,459.35
Total assets	$57,111.77	$155,694.51

Liabilities	Dec. 31, 1941	Dec. 31, 1942
Accounts payable	$ 2,366.77	$ 14,028.06
Bonds, notes, and mortgages payable	17,478.70	77,798.73
Accrued taxes	6,249.06	18,184.50
Other liabilities	1,362.37	- - -
Surplus reserves	2,427.35	2,427.35
Capital stock	8,453.00	8,453.00
Earned surplus and undivided profits	18,774.52	34,802.87
Total liabilities	$57,111.77	$155,694.51

The petitioner received $75,729.17 in 1941 and $137,504.96 in 1942 as compensation from all sources for flight instruction. It derived additional income of $4,176.63 in 1941 and $2,711.73 in 1942 from charter flights, the storage and repair of private planes, and miscellaneous sales and services. The petitioner has not contested determinations of the Commissioner which held that its net income for 1941 was $22,530.19 and that its net income for 1942 was $24,880.08.

The petitioner failed to signify its desire to be exempt from excess profits tax as a personal service corporation on its original 1941 income tax return and it filed an excess profits tax return. An amended 1941 income tax return was filed on or about March 15, 1944, to which was attached a personal service corporation return of income (undistributed Supplement S net income). An amended excess profits tax return was filed on or after May 29, 1944, in which it was stated that petitioner was not subject to excess profits tax.

The stipulation of facts is incorporated in its entirety by reference.

OPINION

LEMIRE, *Judge:* The main question for decision is whether the petitioner is a personal service corporation within section 725(a) of the Internal Revenue Code.[1]

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1. Sec. 725. PERSONAL SERVICE CORPORATIONS. (As added by section 201 of the Second Revenue Act of 1940.)

(a) *Definition.*—As used in this subchapter, the term "personal service corporation" means a corporation whose income is to be ascribed primarily to the activities of shareholders who are regularly engaged in the active conduct of the affairs of the corporation and are the owners at all times during the taxable year of at least 70 per centum in value of each class of stock of the corporation, and in which capital is not a material income-producing factor; but does not include any foreign corporation, nor any corporation 50 per centum or more of whose gross income consists of gains, profits, or income derived from trading as a principal. For the purposes of this subsection, an individual shall be considered as owning, at any time, the stock owned at such time by his spouse or minor child or by any guardian or trustee representing them.

The respondent concedes that the petitioner has met all of the statutory conditions for qualification except the following:

1. That the petitioner's "income is to be ascribed *primarily* to the activities of shareholders who are regularly engaged in the active conduct of the affairs of the corporation," and

2. That the petitioner's "capital is not a *material* income-producing factor." (Emphasis supplied.)

Similar conditions were provided in the sections of former revenue acts relating to personal service corporations.[2] Then, as now, Congress employed words of degree which required further definition by the courts according to the facts of each case. It is hard to reconcile many of the former decisions. See *William A. Brady Theatre Co. v. Commissioner,* 42 Fed. (2d) 181. For present purposes the apparent conflict in those precedents may be illustrated by reference to four decisions of the Circuit Courts of Appeal, each involving a corporation which conducted a school. In *Shipley School v. McCaughn,* 34 Fed. (2d) 281, and *Strayer's Business College v. Commissioner,* 35 Fed. (2d) 426, cited by the petitioner, the taxpayers succeeded; in *Metropolitan Business College v. Blair,* 24 Fed. (2d) 176, and *Atlanta-Southern Dental College v. Commissioner,* 50 Fed. (2d) 34, cited by the respondent, the taxpayers failed to qualify as personal service corporations. In each of these cases the stockholders were assisted by other teachers and capital was invested in school equipment. The differences between these cases were differences in degree. For example, in the first two cases the amount of capital was $25,000 or

2. Section 200 of both the Revenue Acts of 1918 and 1921 provided in part that

> The term "personal service corporation" means a corporation whose income is to be ascribed primarily to the activities of the principal owners or stockholders who are themselves regularly engaged in the active conduct of the affairs of the corporation and in which capital (whether invested or borrowed) is not a material income-producing factor * * * .

less; in the latter two cases the capital was about $100,000. It is to be noted, however, that the decisions in the first two cases did not consider the school quarters, which were leased, as being part of the capital involved. We have recently held that a valuable leasehold constitutes capital within the meaning of section 725(a). *Fairfax Mutual Wood Products Co.*, 5 T. C. 1279. See *William A. Brady Theatre Co. v. Commissioner*, supra.

In another line of cases the decisions turned upon the percentage ratio of gross income derived from capital to the total gross income of the taxpayers. In *Edward P. Allison Co. v. Commissioner*, 63 Fed. (2d) 553, 558, which is typical, it was said of those cases:

> "It is apparent that no definite percentage ratio of gross income derived from capital sources to total gross income can be fixed as the exact point at which capital becomes a material income-producing factor. The contribution of capital to income is a matter largely of approximation. The way in which capital makes its contribution is important. If utilized in the form of salaries, wages, office rent, etc., it does not make it a material income-producing factor, even though such expenditures are usually essential to the production of income. * * *
>
> "When the use of capital goes further and gives character to a sizeable portion of the operations of the corporation, the percentage of gross income indirectly attributable to capital sources required to render capital a material income-producing factor need not be very great."

The petitioner in the present case has not afforded us with any breakdown of the income derived from its capital. We do not know that it could have done so. Yet there is ample evidence that capital was an income-producing factor in its business. We think that the petitioner has failed to show that it was *not* a material factor.

The petitioner's stock, its mean accumulated earnings

and its average borrowed capital were not less than $24,000 in 1941 and $60,000 in 1942, all of which was invested in facilities and equipment for its flying school. During 1941 it occupied leased quarters. The petitioner's balance sheets show even greater invested and borrowed capital at the end of those years. They also show that it had assets consisting of "furniture, equipment (including airplanes and parachutes) less depreciation" of $34,689.50 at the end of 1941 and $97,910.82 at the end of 1942. The petitioner owned 13 airplanes at the end of 1941 and it purchased 13 additional planes during 1942. The undepreciated cost of the 26 planes was $77,707.80. The petitioner could not have operated its flying school without such equipment.

In the case of *Atlanta-Southern Dental College*, supra, emphasis was given to the large amount of the capital investment, there $100,000. It was said in part (50 Fed. (2d) at 37) that

> * * * As to the tuition fees, it is perfectly plain that they were earned and produced by the use of a plant and equipment without which, no matter how eloquent the teaching of the stockholding professors might have been, no matter how magnetic the influence and drawing capacity of the stockholders, no single student could have been drawn to the school, or if drawn, kept, and instructed there."

In the present case the tuition fees were even more directly related to the use of the petitioner's equipment. The petitioner was compensated for the use, as well as for instruction in the use of airplanes on the basis of flight time. For example, the evidence includes a typical contract with CAA under which the petitioner had to provide two approved airplanes for the first ten students and one additional plane for each additional ten students. Under that contract the flight instruction consisted of not less than 35 hours of flying time of which a minimum of 13½ hours was solo. The petitioner was compensated

in installments upon the completion of scheduled stages of flight time. If any student failed to complete the course, the petitioner received payment at hourly rates not exceeding the aggregate installment for each stage. Thus, the income was earned in large part by the use of the airplanes in which it had invested substantial capital.

On these facts we hold that the petitioner's capital was a material income-producing factor during 1941 and 1942. In so holding it is unnecessary to determine whether the other provisions of the statute have been met. The Commissioner correctly determined that the petitioner was not a personal service corporation within section 725(a).

Decision will be entered for the respondent.

(Opinion)

United States Circuit Court of Appeals

Eighth Circuit.

No. 13,621

On Petition to Review Decision of the Tax Court of the United States

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Graham Flying Service, a corporation,

Petitioner,

vs.

Commissioner of Internal Revenue,

Respondent.

[March 25, 1948]

Mr. William W. Graham for Petitioner.

Mr. Abbott M. Sellers, Special Assistant to the Attorney General (Mr. Theron Lamar Caudle, Assistant Attorney General, Miss Helen R. Carloss, Special Assistant to the Attorney General, and Mr. A. F. Prescott, Special Assistant to the Attorney General, were with him on the brief) for Respondent.

Before GARDNER, THOMAS and COLLET, Circuit Judges.

GARDNER, Circuit Judge, delivered the opinion of the Court.

This matter is before us on petition to review the decision of the Tax Court of the United States, which determined deficiencies in petitioner's income taxes for the years 1941 and 1942. The controversy is directed to the question whether the petitioner is a personal service corporation within the meaning of Section 725(a) of the Internal Revenue Code. If so, it was exempt from the excess profit taxes assessed against it for the years 1941 and 1942. If not, the assessment was correct. It is therefore necessary to give consideration to the definition of a personal service corporation. Section 725 of the Internal Revenue Code defines such a corporation in the following words:

"As used in this subchapter, the term 'personal service corporation' means a corporation whose income is to be ascribed primarily to the activities of shareholders who are regularly engaged in the active conduct of the affairs of the corporation and are the owners at all times during the taxable year of at least 70 per centum in value of each class of stock of the corporation, and in which capital is not a material income-producing factor; * * * ."

The Treasury Regulations promulgated under this section of the Revenue Code contain, among other things, the following:

"(c) Income to be ascribed primarily to the activities of shareholders.—If employees other than shareholders contribute substantially to the services rendered by a corporation, such corporation is not a personal service corporation unless, in every case in which services are so rendered, the value of and the compensation charged for such services are to be attributed primarily to the experience or skill of the shareholders and such fact is evidenced in some definite manner in the normal course of the business or profession. The fact that the shareholders give personal attention or render valuable services to the corporation as a result of which its earnings are greater than those of a corporation engaged in a like or similar business or profession, the shareholders of which are not regularly engaged in the activities of the corporation, does not of itself constitute the corporation a personal service corporation."

During the years involved the petitioner was engaged in conducting a flying school at Sioux City, Iowa. E. L. Graham owned 96 per cent of its capital stock and was its president and general manager. His wife and brother each owned 2 per cent of the stock and were respectively secretary and vice president of the corporation. Graham devoted his entire time to the conduct of petitioner's business and had sole charge of its affairs. He was an experienced flyer and was licensed as a commercial pilot. In 1939 he operated a flying school for profit in connection with the Civil Aeronautics Administration. In 1940 he incorporated as Graham Flying Service with an issued capital stock of $8,423.00, which was issued in exchange for certain personal property, including five planes, transferred to the corporation by Graham. During 1941 petitioner operated from a leased airfield, but in 1942 it purchased a field for approximately $21,000.00, and during that year spent $8,000.00 for the construction of an administration building, office, repair shop and hangers. It also purchased airplanes, parachutes and repair parts for training purposes. At the end of 1941, it owned thirteen airplanes which had cost $34,960.42, and at the end of

1942, it owned twenty-six airplanes which had cost $77,707.80. During the year 1941, petitioner's borrowed capital amounted to $8,741.62, and during the year 1942, it amounted to $34,399.34. The entire capital for the two taxable years was employed to purchase facilities and equipment to conduct the flying school.

Graham was chief instructor and flight examiner. In 1941 he taught one complete course of apprentice instructors and one complete course of secondary students. During 1941 and 1942 he gave spot checks, flight checks and final flight tests to many students and personally flew with 90 per cent of the students. The remaining tests were given by representatives of the Civil Aeronautics Administration. He devoted about 70 per cent of his time to instruction and about 20 per cent to supervision of other instructors, and about 10 per cent to management duties. In 1941 he was assisted by five instructors, three mechanics and two office employees. These employees were paid $24,537.14. In 1942 he was assisted by eleven instructors, four mechanics, three office employees and three guards, who were paid $45,064.33. Graham's salary was $3,600.00 in 1941 and $9,600.00 in 1942.

As of December 31, 1941, petitioner's assets were of the value of $57,111.77, and as of December 31, 1942, its assets were of the value of $155,694.51. The compensation received by petitioner for flight instruction during 1941 was $75,727.17 and for 1942, $137,504.96. In addition to this income, in 1941 it received $4,178.65 from charter flights, storage and repairs on planes not owned by it, and miscellaneous sales, and in 1942 it received from like sources the sum of $2,711.73.

The Tax Court held that the petitioner's capital was a material factor in producing its income for the years in question, and hence, that it was liable for excess profit taxes for those years. This determination by the Tax Court is presumptively correct. The facts are undisputed but the conclusion or inference to be drawn from them is

a mixed question of law and fact. The statute enumerates certain prerequisites as necessary to a classification as a personal service corporation. One of the requisite conditions is that "capital is not a material income producing factor." The record discloses that for the year 1941 petitioner's capital was in excess of $50,000.00, and for the year 1942 it was in excess of $150,000.00. Some $29,000.00 was used by it in 1942 to purchase an airfield and to construct facilities thereon. The remaining capital was apparently used for the purchase of aircraft and parachutes, all essential to the business which petitioner was conducting.

In *Edward P. Allison Co. v. Commissioner*, 8 Cir., 63 F. 2d 553, the taxpayer contended that it was entitled to be classified as a personal service corporation. It was engaged in two types of business, one general electric construction, and the other supervising such construction done by others. While the construction work produced greater gross income it also involved very heavy expenses so that the supervisory function according to the taxpayer's accounting was responsible for all of its profit. In the course of the opinion it is, among other things, said:

"The contribution of capital to income is a matter largely of approximation. The way in which capital makes its contribution is important. If utilized in the form of salaries, wages, office rent, etc., it does not make it a material income-producing factor, even though such expenditures are usually essential to the production of income. • • •

"When the use of capital goes further and gives character to a sizeable portion of the operations of the corporation, the percentage of gross income directly attributable to capital sources required to render capital a material income-producing factor need not be very great."

Counsel places great emphasis upon the importance of the services of petitioner's manager and principal stockholder, and certainly they were very considerable and very essential to the success of its business and the pro-

duction of its income. But can it be said that without the airfield and without the aircraft and other facilities, Mr. Graham's activities could have produced the income earned by this corporation during the years in question? The capital was not solely utilized in the form of salaries, wages, office rent, etc., but it surely went further and gave character to a substantial portion of petitioner's operations. There was no proof showing what portion of the income was attributable to personal services and what portion was attributable to invested capital, and it was incumbent upon petitioner to prove that its income was not properly attributable to the use of its capital. We can not say that the use of capital was merely incidental to the conduct of petitioner's business. The invested capital was certainly not nominal and the evidence and stipulated facts warrant the conclusion that the business of petitioner could not have been successfully conducted, nor the income produced, without the use of large sums of money. Under such circumstances petitioner was not entitled to be classified as a personal service corporation. *Edward P. Allison Co. v. Commissioner of Internal Revenue,* supra,; *Crider Bros. Comm. Co. v. Commissioner,* 8 Cir., 45 F. 2d 974; *Denver Livestock Comm. Co. v. Commissioner,* 8 Cir., 29 F. 2d 543; *St. Paul Abstract Co. v. Commissioner,* 8 Cir., 32 F. 2d 225.

The case of *Atlanta-Southern Dental College v. Commissioner,* 5 Cir., 50 F. 2d 34, bears close analogy to the instant case. In that case the taxpayer conducted a dental school, including a dental infirmary, as an essential part of the instruction. There was invested capital of over $100,000.00. In the course of the opinion the court, observing that the decision of the Board of Tax Appeals should be sustained on the grounds specifically relied upon by the Board, held that it should be sustained "upon the further ground that it admits of no contrary opinion that the capital employed by petitioner in the conduct of its business was a material income producing factor, both as to the monetary returns which came directly from the

operation of the dental infirmary, and as to the tuition fees themselves. As to the tuition fees, it is perfectly plain that they were earned and produced by the use of a plant and equipment without which, no matter how eloquent the teaching of the stockholding professors might have been, no matter how magnetic the influence and drawing capacity of the stockholders, no single student could have been drawn to the school, or if drawn, kept, and instructed there."

So in the instant case, Mr. Graham and his corps of instructors could not successfully have conducted his flying school without the aircraft equipment and airfield which represented capital investment. The contracts which petitioner had with the Civil Aeronautics Administration required that it have a certain ratio of approved aircraft to the students, and required that it maintain equipment and facilities in accordance with standards prescribed. We think the decision of the Tax Court warranted by the undisputed facts and that it has a "reasonable basis in the law." *Dobson v. Commissioner*, 320 U. S. 489. The decision of the Tax Court is therefore affirmed.

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In the Supreme Court of the United States

OCTOBER TERM, 1948

No. 108

GRAHAM FLYING SERVICE, A CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (R. 7-16) is reported in 8 T.C. 557. The opinion of the Circuit Court of Appeals (R. 31-37) is reported in 167 F. 2d 91.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on March 25, 1948. (R. 37-38.) The petition for a writ of certiorari was filed on June 21, 1948. The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the courts below correctly held that the taxpayer was a corporation in which capital was a material income-producing factor and therefore ineligible for exemption from excess profits taxes as a personal service corporation under Section 725(a) of the Internal Revenue Code.

STATUTES AND REGULATIONS INVOLVED

These are set out in the Appendix, *infra,* pp. 11-16.

STATEMENT

The facts as stipulated (R. 23-25) and as found by the Tax Court (R. 8-13) are as follows:

During 1941 and 1942 taxpayer was a corporation conducting a flying school near Sioux City, Iowa. E. L. Graham owned ninety-six percent of its capital stock and he was president and general manager. He devoted his entire time to taxpayer's business and conducted its affairs in any manner he saw fit. Graham's wife and brother each owned two percent of taxpayer's stock. They were secretary and vice-president, respectively, but neither they, nor any of taxpayer's employees, had anything to do with the management of the business. (R. 8-9.)

Graham had considerable experience in flying and maintaining aircraft and was licensed as a commercial pilot. In 1939 he operated a flying school for profit in conjunction with Morningside College, under a contract with the Civil Aeronautics Administration, hereinafter sometimes referred to as C. A. A. The college conducted the

ground school phase of the instruction, and Graham taught some of these classes without compensation. Taxpayer was incorporated in 1940, and thereafter operated the flying school. (R. 9.)

Taxpayer's capital stock was $8,453, which was issued in exchange for personal property furnished by Graham (R. 24), including five planes (R. 11).

Under the terms of various contracts with C. A. A., taxpayer was required to provide a certain ratio of licensed instructors and approved aircraft to students assigned by the college, and to furnish dual, check, and solo instruction in accordance with prescribed flight curricula and specified schedules of flying time. Taxpayer provided instruction for between three hundred and four hundred students during 1941 and 1942, consisting principally of a primary and a secondary course. The secondary course required a heavier plane. Taxpayer received specified sums for each student who completed the respective courses. Also, it offered courses for training flight instructors, and commercial and cross-country pilots. Hourly rates were charged for uncompleted courses. (R. 9-10.)

Graham was taxpayer's chief instructor and only flight examiner. He also held a certificate for aircraft maintenance. In 1941 he taught one complete class of apprentice instructors and also one complete class of secondary students. He knew practically all the students personally. In 1941 and 1942 Graham gave spot checks, flight checks, and final flight tests to many students. He per-

sonally flew with and either examined or instructed ninety percent of taxpayer's students. The remaining tests were given by representatives of C. A. A. Graham worked from daylight to dark, usually seven days a week. He devoted about seventy percent of his time to instruction, including checks and tests, about twenty percent to supervision of other instructors, and about ten percent to management duties. In 1941 he was assisted by five instructors, three mechanics and two office employees, who earned $24,537.14. In 1942 there were eleven instructors, four mechanics, three office employees, and three guards, who earned $45,064.33. Graham's salary was $3,600 in 1941 and $9,600 in 1942. (R. 10.)

During 1941 taxpayer operated from a leased airfield, but early in 1942 it purchased a field for approximately $21,000, making an initial payment of $3,000 from accumulated earnings. It spent $8,000, about half of which it borrowed, for construction of an administration building, office, repair shops, and hangars. (R. 10.) Also, it purchased airplanes, parachutes, and repair parts for training purposes. At the end of 1941 taxpayer owned thirteen airplanes which had cost $34,960.42, and at the end of 1942 it owned twenty-six airplanes which had cost $77,707.80. Most of the planes were purchased by making a down payment of ten percent from earnings and borrowing the balance of the purchase price from the Reconstruction Finance Corporation, the aircraft and the C. A. A. contracts being used as security. For a

short period in 1941 two airplanes were rented. (R. 11.)

Fuel and oil used in taxpayer's smaller planes cost from $1 to $1.20 per hour. The cost of gasoline alone for the larger planes was from $10.50 to $11 per hour. Taxpayer charged $8 per hour for the smaller planes and $15 to $18 per hour for the larger planes when they were rented on occasion to pilots, which charges included fuel and oil. The cost of plane operation and maintenance was $16,806.63 for 1941 and $23,192.12 for 1942. (R. 11.)

Taxpayer's average borrowed capital was $8,742.62 in 1941 and $34,399.34 in 1942. The entire capital for the two taxable years was used to purchase facilities and equipment to conduct the flying school. (R. 11.)

Taxpayer's balance sheets as of the end of 1941 and 1942 were as follows (R. 11-12):

Assets:

	Dec. 31, 1941	*Dec. 31, 1942*
Cash	$7,363.38	$1,191.46
Notes and accounts receivable	11,958.78	48,898.05
Inventories	384.34	844.83
Deposit on airplane	125.00	390.00
Furniture, equipment (including airplanes and parachutes) less depreciation	34,689.50	97,910.82
Prepaid expenses	2,590.77	6,459.35
Total assets	57,111.77	155,694.51

Liabilities:		
Accounts payable	$2,366.77	$14,028.06
Bonds, notes, and mortgages payable	17,478.70	77,798.73
Accrued taxes	6,249.06	18,184.50
Other liabilities	1,362.37	
Surplus reserves	2,427.35	2,427.35
Capital stock	8,453.00	8,453.00
Earned surplus and undivided profits	18,774.52	34,802.87
Total liabilities	57,111.77	155,694.51

The compensation received by taxpayer from all sources for flight instruction was $75,729.17 for 1941 and $137,504.96 for 1942. In addition, taxpayer derived income of $4,176.63 in 1941 and $2,711.73 in 1942 from charter flights, the storage and repair of planes not owned by it, and miscellaneous sales and services. Its net income was $22,530.19 for 1941 and $24,880.08 for 1942. (R. 12.)

In its original 1941 income tax return taxpayer failed to elect to be exempt from excess profits tax as a personal service corporation, and it filed an excess profits tax return. An amended 1941 income tax return was filed on or about March 15, 1944, to which was attached a personal service corporation return of income (undistributed Supplement S net income). An amended excess profits tax return was filed on or after May 29, 1944, in which it was stated that taxpayer was not subject to excess profits tax. (R. 12-13.)

The Commissioner determined that taxpayer was not a personal service corporation for 1941 and 1942. The Tax Court sustained the Commissioner. It held that taxpayer's capital was a material income-producing factor during both years, and that it was not necessary to determine whether the other

provisions of the statute had been met. (R. 16.) The Circuit Court of Appeals affirmed. (R. 37.)

ARGUMENT

The Tax Court and the court below held, correctly we submit, that the taxpayer was not, within the meaning of Section 725(a) of the Internal Revenue Code (Appendix, *infra,* pp. 11-12), a "personal service corporation" since capital invested in the corporation was a "material income-producing factor."

The Tax Court found that the entire capital of the corporation for the two taxable years was employed to purchase facilities and equipment such as planes, parachutes, repair parts, an administration building and an airfield in order to conduct a flying school. At the end of 1941 the corporation owned thirteen airplanes, which had cost nearly $35,000, and at the end of 1942 it owned twenty-six airplanes, which had cost $77,000, and an airfield purchased for $21,000. (R. 10-11.) On December 31, 1941, the taxpayer's assets were valued at about $57,000 and on December 31, 1942, at about $155,000. The income received for flight instruction during 1941 was $75,000 and for 1942, $137,000. (R. 12.) This instruction was given in accordance with contracts with the Civil Aeronautics Administration which required that the taxpayer provide a certain ratio of approved aircraft to students, maintain its equipment and facilities in accordance with prescribed standards and furnish flight instruction in accordance with prescribed flight curricula and within specified schedules of

flying time. (R. 9.) Two courses were given, the second of which, involving the use of heavier planes and requiring about twenty-five per cent more flying hours, cost more than twice as much as the primary course. (R. 9-10.) Both courts below concluded that without the airfield and the aircraft and other facilities taxpayer could not have produced the corporate income and that the use of the capital invested in such equipment could not be considered as being merely incidental to the conduct of the taxpayer's business.[1]

This conclusion is clearly correct. The capital invested in the airplanes and in the airport cannot be considered in the same light as capital utilized in the form of office rent, wages, supplies and incidental expenses.[2] The equipment here was not like an office; rather it was the very thing whose use was required to be made available to students and for which petitioner was paid the income here taxed. Cf. *William A. Brady Theatre Co.* v. *Commissioner*, 42 F. 2d 181, 183 (C.C.A. 2). No reasonable conclusion would seem to be possible other

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[1] This conclusion being sufficient to support the Commissioner's determination it became unnecessary to consider two other contentions which the Commissioner urged, as follows: (1) the income was not primarily ascribable to the activities of the shareholder owning more than 70 per cent of the corporate stock; (2) the taxpayer did not make the timely election required by Section 725(b), Internal Revenue Code, to be classified as a personal service corporation for 1941.

[2] *Edward P. Allison Co.* v. *Commissioner*, 63 F. 2d 553 (C.C.A. 8); *Dreyer Commission Co.* v. *Hellmich*, 25 F. 2d 408 (C.C.A. 8); *F. Wallis Armstrong Co.* v. *McCaughn*, 21 F. 2d 636 (E.D. Pa.). These cases were all decided under earlier statutes which, however, do not differ in any material respect from Section 725(a) of the Internal Revenue Code.

than that the income was attributable in large measure to the use of airplanes and other equipment in which substantial capital was invested.

The taxpayer's contention (Pet. 7-10) that the decision below is in conflict with *Shipley School* v. *McCaughn*, 34 F. 2d 281 (C.C.A. 3), and *Strayer's Business College* v. *Commissioner*, 35 F. 2d 426 (C.C.A. 4), misconstrues the nature of the problem under consideration. The question in this case is one of degree since the statute requires that capital be not a *material* income-producing factor. The determination of such a question is basically for the trier of the facts and each case must necessarily depend upon the particular facts shown. The two cited cases turned on the application of similar statutory provisions,[3] but dealt with schools in no way comparable to the kind operated by this taxpayer. In the *Shipley* case, the capital invested was in furniture and equipment not in excess of $25,000, and the income of the school was found to be derived essentially from the relationship of the two owners of the school to their pupils based on their personal attention, teaching and exclusive oversight. In the *Strayer* case, the capital amounted to but $5,000 and was used chiefly for the purchase of furniture and equipment. The capital thus employed was deemed but nominal and incidental to the operation of the business.

The factual differences between those cases and the present case are obvious. The alleged con-

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[3] Revenue Act of 1921, c. 136, 42 Stat. 227, Sec. 200; Revenue Act of 1918, c. 18, 40 Stat. 1057, Sec. 200.

flict would exist only if the statute were construed so as to include every type of school regardless of the nature of the school equipment and the amount of capital invested therein. No case decided by any of the courts would support such a conclusion. The basic test is "the way in which capital makes its contribution" to income (*Edward P. Allison Co.* v. *Commissioner,* 63 F. 2d 553, 558 (C.C.A. 8)) and this must be determined on the facts of each case.

CONCLUSION

The decision of the court below is correct, there is no conflict of decisions, and the case does not warrant further review. The petition should, therefore, be denied.

Respectfully submitted,

PHILIP B. PERLMAN,
Solicitor General.
THERON LAMAR CAUDLE,
Assistant Attorney General.
GEORGE A. STINSON,
ABBOTT M. SELLERS,
S. WALTER SHINE,
Special Assistants to the Attorney General.

JULY, 1948.

APPENDIX

Internal Revenue Code:

SEC. 394 (as added by Sec. 502, Second Revenue Act of 1940, c. 757, 54 Stat. 974). CORPORATION INCOME TAXED TO SHAREHOLDERS.

(a) *General Rule.*—The undistributed Supplement S net income of a personal service corporation shall be included in the gross income of the shareholders in the manner and to the extent set forth in this Supplement.

(b) *Amount Included in Gross Income.*—Each shareholder who, on the last day of the taxable year of the corporation, was a shareholder in such corporation shall include in his gross income, as a dividend, for the taxable year in which or with which the taxable year of the corporation ends, the amount he would have received as a dividend if on such last day there had been distributed by the corporation, and received by the shareholders, an amount equal to the undistributed Supplement S net income of the corporation for its taxable year.

* * * * *

(26 U. S. C. 1940 ed., Sec. 394.)

SEC. 725 (As added by Sec. 201, Second Revenue Act of 1940, c. 757, 54 Stat. 974). PERSONAL SERVICE CORPORATIONS.

(a) *Definition.*—As used in this subchapter, the term "personal service corporation" means a corporation whose income is to be ascribed primarily to the activities of shareholders who are regularly engaged in the active conduct of the affairs of the corporation

and are the owners at all times during the taxable year of at least 70 per centum in value of each class of stock of the corporation, and in which capital is not a material income-producing factor; * * *

(b) *Election as to Taxability.*—If a personal service corporation signifies, in its return under Chapter 1 for any taxable year, its desire not to be subject to the tax imposed under this subchapter for such taxable year, it shall be exempt from such tax for such year, and the provisions of Supplement S of Chapter 1 shall apply to the shareholders in such corporation who were such shareholders on the last day of such taxable year of the corporation. * * *

(26 U. S. C. 1940 ed., Sec. 725.)

Treasury Regulations 109, promulgated under the Internal Revenue Code:

Sec. 30.725–2 (As added by T. D. 5036, 1941–1 Cum. Bull. 276). *Definition of personal service corporation.*— * * *

* * * * *

(c) *Income to be ascribed primarily to the activities of shareholders.*—If employees other than shareholders contribute substantially to the services rendered by a corporation, such corporation is not a personal service corporation unless, in every case in which services are so rendered, the value of and the compensation charged for such services are to be attributed primarily to the experience or skill of the

shareholders and such fact is evidenced in some definite manner in the normal course of the business or profession. The fact that the shareholders give personal attention or render valuable services to the corporation as a result of which its earnings are greater than those of a corporation engaged in a like or similar business or profession, the shareholders of which are not regularly engaged in the activities of the corporation, does not of itself constitute the corporation a personal service corporation.

* * * * *

It may happen that a corporation is engaged in two or more businesses or professions which are more or less related. Thus, an engineering concern may also engage in contracting, which amounts to trading in materials and labor, or a brokerage concern may guarantee some of its accounts, or a photographic concern may sell pictures, frames, art goods, and supplies. In such cases, the corporation is not a personal service corporation unless the activities of the corporation consisting of trading or guaranteeing of accounts or selling are negligible or merely incidental, and unless no appreciable part of the earnings is to be ascribed to such activities. See also (e) below relating to the employment of capital.

* * * * *

(e) *Capital as a material income-producing factor.*—In a personal service corporation capital must not be a material income-producing factor. Whether capital is a material in-

come-producing factor is to be determined by reference to (a) the extent to which capital is required to carry on the business or profession, and (b) the extent to which capital is actually used in the production of income though not required by the primary activities of the corporation. If the use of capital is necessary to the production of the income of the corporation and is more than incidental, capital is a material income-producing factor and the corporation is not a personal service corporation. If a substantial portion of the income is attributable to a use of capital, whether or not connected with the primary activities of the corporation, capital is a material income-producing factor even though such use of capital is not necessary to such primary activities. The term "capital" as used in section 725 and in this section means not only capital actually invested by the shareholders but also capital obtained in other ways. Thus, capital may be borrowed either directly as shown by bonds, debentures, certificates of indebtedness, notes, bills payable, or other paper, or indirectly as shown by accounts payable or other forms of credit, or the business of the corporation may be financed in some other manner by its shareholders. If a substantial amount of capital is used to finance or carry the accounts of clients or customers, it will be inferred that because of competition or for other reasons such use of capital is necessary and more than incidental in order to secure or hold business which would otherwise be lost. If a corporation engaged in an agency, brokerage, or commission business regularly employs a sub-

stantial amount of capital to lend to its principals, to buy and carry goods on its own account, or to buy and carry odd lots in order that it may render more satisfactory service to its principals or customers, such corporation is not a personal service corporation. In general, the larger the amount of capital actually used the stronger is the evidence that capital is necessary and more than incidental and is a material income-producing factor.

The term "income" as used in section 725 and in this section means gross income. Capital is a material income-producing factor if its use results in a substantial amount of gross income, irrespective of the amount of net income, if any, such use produces.

(f) *Application of regulations; returns.*— No definite and conclusive tests can be prescribed by which it can be finally determined in advance of an examination of the corporation's income tax return whether it is or is not a personal service corporation. In the preceding subsections are set forth the general principles under which such determination will be made.

If a corporation claiming to be a personal service corporation signifies in its return under Chapter 1 for any taxable year its desire not to be subject to the excess profits tax under Subchapter E of Chapter 2 for such taxable year, it shall attach Form 1121PS, in duplicate, to its income tax return on Form 1120. In Form 1121PS there shall be stated (a) such facts as tend to show whether or not the corporation is a personal service corporation, in-

cluding (1) the nature of its business, (2) the character, preferences, dividend rates, and other essential features of the various classes of its stock outstanding for any time during the taxable year, (3) the names and addresses of its several shareholders and their relationship to each other, (4) the number and classes of shares owned at any time during the taxable year by each shareholder and the portion of the year during which such shares were so owned, (5) the nature of the activities of the several shareholders on behalf of the corporation, and (6) the extent to which capital in any form is used in the business, and (b) the computation of the undistributed Supplement S net income for the taxable year, the names and addresses of all shareholders of the corporation at the close of the taxable year, the number and classes of shares held by each, and such other information as may be required by the form and the instructions printed on the form or issued therewith.

Sec. 30.725–3 (As added by T. D. 5036, 1941–1 Cum. Bull. 276). *Election as to taxability.*— * * * A new election is required for each taxable year. An amended return filed after the statutory period for filing the return (or after the last day of any extension period) is not a return within the meaning of section 725 (b).

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